RB-2009-01 Guidance on Risk Management: Asset Concentrations

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Risk Management: Asset Concentrations

The Department has growing concerns regarding asset concentrations and related risk management practices. Higher-risk asset concentrations have contributed significantly to an increase in the number of problems being identified during recent examinations. The Department is issuing this Bulletin to emphasize important risk management practices for credit unions' boards of directors and management and to encourage credit unions to revisit their existing concentration policies given the current economic environment.

Each credit union should implement a sound risk management framework to identify, measure, and control the level of concentration risk commensurate with the size and complexity of the institution. The framework should include: specific board and management oversight reports; standards for monitoring and managing the higher-risk concentrations; appropriate management information systems; strong credit underwriting standards; and a robust asset risk review function.

Concentration risk management and mitigation is essential regardless of economic conditions. The Department expects credit unions to develop risk management systems to ensure prudent underwriting and investment standards including board-

approved reasonable limits for higher-risk concentrations. The board should review the risk management systems on a scheduled basis, including adjusting and refining concentration limits.

The Department examiners review a credit union's risk management practices in relation to concentrations that pose significant risks. For example, when there is significant exposure to purchased loans from third parties who control the servicing, disbursement, and collection processes, this relationship requires a more intensive review of the controls. The Department encourages the use of an independent, qualified third-party to review and monitor these relationships. The third-party review can be performed by an outside person or internal staff, but should retain its independence. An independent review is particularly important when the relationship involves higher-risk loans or investments and the institution lacks a strong risk management system.

The following list summarizes lessons learned from recent examinations. The Department examiners will consider these lessons while assessing a credit union's risk management systems.

- Market pressures and competition have compelled some credit unions to lower underwriting standards and loan terms to increase origination volume. Concentrations of loans originated under lowered standards increase risk.
- Higher-risk activities and concentration risks can be masked by financial success during periods of favorable economic conditions. Credit unions with concentration levels in higher risk activities should maintain sufficient net worth buffers in excess of Prompt Corrective Action "Well Capitalized" levels to compensate for the higher risk.
- Rapid growth in asset concentrations should be monitored carefully. Detection of underwriting deficiencies and loan performance weaknesses often occurs after the risk has grown to an excess level.

• Credit-related models are not likely to perform as well in a rapidly deteriorating environment. ALLL provisions methodologies are often based on historic loan performance resulting in reserve levels that do not keep pace with the current loan performance and losses. During economic fluctuations, management should shorten the "lookback" period for portfolio performance to ensure sufficient ALLLs.

The Department encourages credit unions to provide credit to qualified members for consumer and business purposes, provided that such credit is extended in a safe and sound manner. Credit unions must also document each borrower's willingness and ability to repay. Such documentation should be commensurate with the size and risk of the respective extensions of credit. Credit unions should ensure they adhere to prudent underwriting practices, particularly for loan portfolios with higher risk concentrations. Credit unions should not allow competitive pressures to erode the quality of underwriting.

Department examiners will closely review and scrutinize higher risk concentrations during examinations. These reviews will assess management and the Board's ability to establish appropriate concentration limits and implement effective risk management systems. The Department will exercise supervisory discretion in limiting or curtailing activities to prevent and limit unsafe and unsound business activities. The Department will pursue corrective action or enforcement action when a credit union does not maintain appropriate concentration limits or takes excessive risks.